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‘Strategic reporting’ of conduct costs

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On 1 October 2013, the Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013 came into effect. The material change introduced by the Regulations was a requirement for certain companies to prepare a strategic report as part of their annual report (s. 414C of the CA 2006). This will apply for periods ending on or after 30 September 2013. The ‘strategic report’ replaces the ‘business review’ and, as the Financial Reporting Council (FRC) advocates, will encourage disclosures that *“provide shareholders with a holistic and meaningful picture of an entity’s business model, strategy, [risks], development, performance, position and future prospects.”*

A background to, plus a detailed discussion of the key requirements of, the Regulations can be found within the FRC’s [draft] Guidance on the Strategic Report (see: http://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report-File.pdf).

The Regulations, and specifically, the strategic report, are the manifestation of the Government’s intention to reform corporate reporting in a way that engenders more materially relevant, qualitative (or narrative) disclosure. The strategic report should provide shareholders of the company with the ability to assess how the directors have performed their duty to promote the success of the company for their collective benefit. In particular, is a requirement to include a *“description of the principal risks and uncertainties facing the company.” (s. 414C(2)(b))*

Could this be the basis for conduct risk disclosure (to the extent that it is ‘material’)? Will the trend toward more qualitative narrative reporting, as propounded by the strategic reporting requirements, cast a new light on what disclosure is necessary to demonstrate directors’ performance against their s.172 CA 2006 duty? Or is it going a tad far to suggest that we may find that conduct risk and associated costs (and provisions) are disclosed on the basis that this represents a strategic and material risk to the business and thus, the net effect of the s.172 duty and the strategic reporting requirements demands it? After all, directors are required to act in a way that promotes the success of the company having regard to *“the desirability of the company maintaining a reputation for high standards of business conduct.” (s. 172(1)(e))*

s. 414C(7) might be the catalyst here, as it requires quoted companies’ strategic reports to include *“the main trends and factors likely to effect the future developments, performance and position of the company’s business.”* s.414C(8) goes on to require strategy and business model disclosure.
However, s. 414C(14) provides the exception by stating that nothing in s.414C *“requires the disclosure of information about pending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.”*

Nevertheless, the policy objective of the strategic report is to require companies to make disclosures that meet the information needs of shareholders. Accordingly, where the company is subject to conduct risk that manifests in incurred and/or anticipated material economic costs, should companies not then be required to report to shareholders on this? Quite possibly, but this commentator does not believe that this will lead to specific conduct costs disclosure beyond that already required by the UK Corporate Governance Code (C1.2) or the Disclosure and Transparency Rules (4.1.8-11) – certainly not, in regard to future costs exposure. And, neither should it, where s. 414C(14) is properly employed. Having said that, the refocused disclosure rules may engender more qualitative reporting, which may lead to better and more meaningful disclosures on conduct risk/costs i) where FRC guidance is interpreted as promoting this (see below) and/or ii) it leads to changes in what is considered 'good conduct-disclosure-practice'.

The test of 'materiality' will be the essence of the debate, which of course, rests in the subjective opinion of the company, not shareholders (and to an even more remote extent, 'stakeholders'). Although, conduct costs disclosure is becoming, ever more, a 'material' issue. Consider i) the Global Reporting Initiatives, reporting indicators SO8 and PR9, ii) the regulators view that conduct risk/costs is a matter of prudential [capital and risk] significance (see LSE blog article 'the right and proper financial consequences to (mis)conduct) and iii) the views of other stakeholders (see LSE blog article 'access to information as a driver for compliance').

The FRC's guidance is in draft form and is expected to be finalised early 2014. It is nevertheless of note that the FRC considers that whilst *"information regarding the settlement of a material legal claim against an entity may not be considered 'strategically significant' information", "it is, however, important contextual information relating to the period under review which should be included in the strategic report."* (FRC, Exposure Draft: Guidance on the Strategic Report (August 2013) para 6.12). Equally, the FRC draft guidance states that:

"the way an entity conducts its business in relation to [its employees (s.414C(7)(b)(ii))] may affect its licence to operate/trade in a particular location or market, or result in a major event that will directly or indirectly affect the entity (e.g. a material litigation, loss of revenue or reparation cost). The risk of such an event may constitute a principle risk or uncertainty to the entity"

In the context of the Regulations and specifically the strategic report disclosures, the conflict between 'materiality' and the potential for 'serious prejudice to the interests of the company' as a result of conduct costs disclosure, is where opinions will differ most.

Let's wait and see where we go from here…